BKD

Advisor

Beyond Your Numbers

November 2006

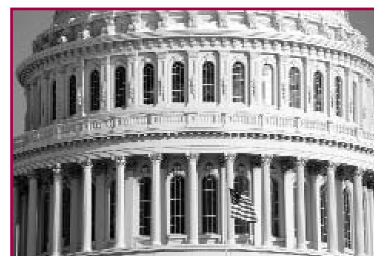
A Special Year-end Planning Issue

2006 tax year in perspective

This special year-end issue focuses on recent tax law changes and planning strategies that may help individuals and businesses reduce their 2006 tax liability and plan for 2007. Also included are notable strategies and topics from BKD Corporate Finance and BKD Wealth Advisors.

This year, two significant new tax laws were passed—the *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA) and the *Pension Protection Act of 2006* (Pension Act). More changes are expected in 2007.

As we go to press, the outcome of the mid-term Congressional elections is not known, but some sort of tax legislation is expected next year. The government's actions on meaningful, large-scale tax reform have fizzled for the time being but may be resurrected depending on the November election results.



The current Congressional tax focus is the "tax gap" (basically, unpaid taxes) and ways to reduce the number of individuals and businesses that underreport income. Congress is also focused on exempt organizations and estate tax reform.

One big question in the minds of many taxpayers is the alternative minimum tax (AMT). Congress provided a temporary, one-year reprieve for many individual taxpayers for 2006 but has yet to provide relief for 2007 or future years. In the absence of relief, many more taxpayers will be subject to AMT in 2007 and future years.

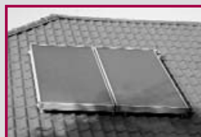
The year ahead may also bring significant regulatory changes. When the Internal Revenue Service (IRS) building in Washington, D.C., was flooded this summer, the IRS was forced to move to temporary quarters, delaying certain regulatory and guidance projects.

Significant issues concerning partnerships, deferred compensation arrangements, treatment of repair costs and others may be covered by new regulations in the near future.❖❖❖

Conserve energy & save: new tax incentives for 2006

You may be able to take advantage of one or more of the following energy conservation-related tax incentives, new for 2006:

- Tax credits for the purchase of hybrid, fuel cell, advanced lean burn and other alternative-power vehicles placed in service after 2005
- 30% tax credit for the purchase of qualifying residential solar water heating, photovoltaic equipment and fuel cell property placed in service in 2006 and 2007



- 30% business tax credit for the purchase of certain power plants
- 10% personal tax credit for energy-efficient improvements to your principal residence; the lifetime maximum credit per taxpayer is $500, and it applies to property placed in service in 2006 and 2007
- Business tax credit for contractors who construct energy-efficient new homes; depending on the type of home and the energy-reduction standard it meets, the per-home credit is either $2,000 or $1,000 and applies to homes with construction substantially completed after December 31, 2005, that are purchased after December 31, 2005, and before January 1, 2008
- Deduction for energy-efficient commercial buildings placed in service in 2006 and 2007 that meet a 50% energy reduction standard; generally, the deduction is $1.80 per square foot, but it is 60 cents per square foot in some cases
- Manufacturers' tax credit for energy-efficient dishwashers, clothes washers and refrigerators manufactured in 2006 and 2007❖❖❖

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BKD summary: *Pension Protection Act of 2006*

Signed into law August 17, 2006, the *Pension Protection Act of 2006* (the Act) makes many pension reforms, revises some of the rules governing charitable giving and makes a number of reforms that will affect exempt organizations.

The following includes highlights for businesses and individuals.

Defined benefit plan reforms

The main emphasis of the Act is to reform defined benefit pension plans. While 401(k) plans have become the pension plan of choice for most employers, many still have defined benefit plans, especially companies with union employees.

Defined benefit plans provide a set retirement benefit regardless of market conditions. The Act provides additional pension protection for employees, and it reforms plan design and operation.

The general principle is that a plan's required contribution equals the present value of benefits earned by participants during the current year, plus the amount needed to amortize any funding shortfall over no more than seven years.

In the case of severely underfunded plans, special rules—**generally effective in 2008**—will increase the funding obligation. The Act also extends for 2006 and 2007 the funding relief previously enacted in 2004.

Defined contribution plans

The most popular defined contribution plan is the 401(k) plan. The Act encourages the adoption of automatic enrollment 401(k) plans by pre-empting state laws that might affect them and providing additional nondiscrimination safe-harbor protections.

Other changes also affect the way defined contribution plans operate:

- Limits placed on an employer's ability to mandate a plan's investment in employer stock
- Easier for sponsors to provide investment advice to plan participants
- Fewer restrictions on plan investments and certain prohibited transactions
- Certain small employers permitted to create linked 401(k) and defined benefit plans

Permanency of prior law

The Act makes permanent more than three dozen rules affecting IRA and retirement plan sponsors and participants that were scheduled to sunset at the end of 2010, such as the Roth 401(k) account option and Section 529 college savings plans.

Reporting requirements

The Act contains several provisions that affect access to plan information. For plan years beginning after 2007, it requires certain Form 5500 information be made available on the Internet.

Further, for plan years beginning after 2006, it **requires** plan administrators to provide quarterly benefit statements to defined contribution plan participants and beneficiaries who have the right to direct the investment of plan assets and annual statements to those participants and beneficiaries without such investment rights.

For plan years after 2006, the Act eliminates the Form 5500 filing requirement for certain one-participant and partner-only plans with less than $250,000 in assets and simplifies the reporting obligations of plans with fewer than 25 participants.

Making charitable contributions

The Act makes a few notable changes that affect donations for charitable contributions:

- The new law effectively ends deductions for out-of-pocket cash donations unless a receipt is obtained from the recipient organization or a cancelled check or other proof is maintained. If you simply drop a $50 bill in the Sunday collection, you will not be able to deduct it without a receipt or other proof. Your best bet is to make such donations via check and keep a copy of the cancelled check.

- If you donate clothing or household goods to a charity, you are generally eligible for a deduction in the amount of the fair market value of the property. Under the new law, no deduction is allowed for such donations unless the clothing or household items are in good condition. Deductions of more than $500 are exempted if a qualified appraisal is included with your tax return. Food, paintings, antiques and other objects of art, jewelry and gems and collections are excluded.
- For donations after September 1, 2006, the new law imposes a new recapture rule on donors of tangible personal property with a claimed deduction value of more than $5,000. If the charity sells the donated property within three years, you generally will have to include a portion of your deduction in income. Exceptions apply but be careful when donating tangible personal property to a charity if you think it will turn around and sell it.
- For 2006 and 2007 only, the new law gives IRA participants age 70½ or older the ability to donate IRA assets to charity at no tax cost. The Act does this by eliminating the requirement that eligible taxpayers recognize the IRA distribution as income and then take a charitable deduction, a process that almost always results in tax. This only applies to transfers made directly from the IRA to the charity and only up to $100,000 annually.

Exempt-status reforms

The Act makes notable reforms for exempt organizations, including:

- Under pre-Act law, interest, rents, royalties and annuities that a tax-exempt organization receives from a 50% or more controlled subsidiary is taxable unrelated business income (UBI) to the extent the payment reduces the taxable income of the subsidiary. For payments received or accrued after 2005 and before 2008, the Act provides such receipts are not included in UBI to the extent they are based on arms-length standards. However, excess payments remain subject to UBI tax, plus a new 20% penalty.
- The Act includes a temporary reporting requirement where a tax-exempt organization acquires an interest in a life insurance, annuity or endowment contract, and another person also owns an interest in the contract. The purpose of this requirement is to help the IRS spot potential abuses.

- The Act doubles the amount of excise taxes applicable to organizations and managers on certain excess benefit transactions and acts of self-dealing.
- For purposes of the net investment income excise tax, and for tax years beginning after August 17, 2006, the Act amends the definition of gross investment income for private foundations to include capital gains, notional principal contracts, annuities and other substantially similar investment income.
- For notices and returns with respect to annual periods beginning after 2006, the Act requires organizations that do not have an annual filing requirement (because their gross receipts are less than $25,000) to file an annual notice with the IRS containing basic contact and financial information.
- **For returns filed after August 17, 2006**, the Act extends the public inspection and disclosure requirements and penalties applicable to the Form 990 to the UBI tax return (Form 990-T).
- **For transactions after August 17, 2006**, the Act applies an excess benefits transaction tax on any grant, loan, compensation or other similar payments from a donor-advised fund to a person who, with respect to such fund, is a donor, donor advisor or a related person, and from a supporting organization to a substantial contributor or a related person. For tax years beginning after the enactment date, subject to transition rules, the Act imposes excess business holdings rules on donor-advised funds, Type III supporting organizations and certain Type II organizations. ❖❖❖

Individual year-end tax planning strategies

Reduce taxable income with an IRA

One way to reduce your 2006 taxable income is to make a tax-deductible contribution to a traditional individual retirement account (IRA). You have until April 16, 2007, to make the actual funds transfer to your IRA.

If neither you nor your spouse actively participate in your employers' retirement plans, you may make an annual deductible cash contribution to a traditional IRA up to the lesser of $4,000 per person ($5,000 if age 50 or older) or 100% of your taxable compensation. If you **or** your spouse actively participates in your employers' retirement plans, your IRA deduction phases out based on your income.

If you are a married couple and **one** of you is an active plan participant but the other is not, the otherwise allowable deductible contribution will be phased out ratably for modified AGI between $150,000 and $160,000 in 2006 and $156,000 and $166,000 in 2007. If you file the long form, modified AGI is the figure at the bottom of page one of Form 1040, increased by certain amounts such as tax-exempt interest.

If you are a married couple and **both** of you are active plan participants, the otherwise allowable deductible contribution will be phased out ratably if your modified AGI is between $75,000 and $95,000 in 2006 and $83,000 and $103,000 in 2007.

If you are unmarried, your otherwise deductible contribution will be phased out ratably if your modified AGI is between $50,000 and $60,000 for 2006 and $52,000 and $62,000 for 2007.

Roth IRAs

You also may be eligible to make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions. While a traditional IRA provides for tax-deductible contributions, distributions from a traditional IRA are taxable. Contributions to a Roth IRA are not deductible, but distributions from a Roth IRA are generally not taxable.

The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with modified AGI over certain levels for the tax year. A married couple filing a joint return can contribute $4,000 per person ($5,000 if age 50 or older) in 2006 if modified AGI is less than $150,000 ($156,000 for 2007).

Unmarried individuals can contribute the full amount for 2006 if modified AGI is less than $95,000 ($99,000 for 2007). You can also convert your traditional IRA to a Roth if your modified AGI is less than $100,000 (**$50,000 if single or married filing separate**).

Beginning in 2010, the $100,000 limit will be eliminated. In addition, for conversions occurring in 2010, the amounts to be included in income will be spread ratably between 2011 and 2012.

This creates a potential planning opportunity for taxpayers whose modified AGI is too high to contribute to a Roth or a traditional IRA. Such taxpayers can make nondeductible contributions to a traditional IRA and convert to a Roth IRA in 2010. In that case, only the investment earnings will be taxed and the tax will be deferred to 2011 and 2012.

Donate appreciated securities

In 2006 or 2007, group your charitable contributions so you can obtain the highest number of tax benefits possible. If you move to a higher tax bracket in 2006, consider accelerating charitable contributions in 2006. Do the opposite if you'll be in a higher tax bracket in 2007.

If you can, donate stock or other securities instead of cash. That way, your deduction will generally equal the value of the property, and you will avoid any regular income tax on the appreciation in value.

What if you own a security that you think will continue to appreciate in value—wouldn't it be better to keep the property and donate cash? Usually not, because you can donate the security *and* use the cash you were going to donate to purchase more such securities.

Not only will you get a deduction equal to the full, fair market value of the security, but you will also have a higher basis in the newly acquired property, which reduces the amount of gain you'll recognize if you sell it in the future.

Note: Contributions of appreciated capital gain property are limited to 30% of your AGI.

Donating from an IRA

If you are a charitable-minded individual at least age 70½ and you

Some of the information in this *BKD Advisor* is specific to 2006 and may not be relevant after December 31, 2006. As always, talk with your BKD advisor before taking any action.

Contact your BKD advisor to schedule a presentation on tax planning strategies for members of your community, business, civic or charitable organizations.

have an IRA, consider donating up to $100,000 of it to charity. Under the Pension Act, as previously discussed, the IRA distribution will not be taxable to you.

Such a donation will not be subject to the 50%-of-AGI limitation, plus it will not be subject to the phase out of itemized deductions for higher-income taxpayers.

Be careful when donating vehicles

When donating an automobile, boat or plane to charity, special rules apply (to limit your charitable deduction) that depend on how the charity uses the vehicle.

If the charity sells the vehicle without significant intervening use or material improvement, your deduction generally can't exceed the gross proceeds from the charity's sale. Though charities are required to provide you with an acknowledgement indicating whether they intend to sell, use or improve a donated vehicle, you should still inquire.

Individual Tax Rate Schedule

Status	2006 Rates Rate (%)	2006 Rates Bracket	Estimated 2007 Rates Rate (%)	Estimated 2007 Rates Bracket*
Single	10%	$0 - 7,550	10%	$0 - 7,825
	15	7,551 - 30,650	15	7,826 - 31,850
	25	30,651 - 74,200	25	31,851 - 77,100
	28	74,201 - 154,800	28	77,101 - 160,850
	33	154,801 - 336,550	33	160,851 - 349,700
	35	Over 336,550	35	Over 349,700
Head of Household	10%	$0 - 10,750	10%	$0 - 11,200
	15	10,751 - 41,050	15	11,201 - 42,650
	25	41,051 - 106,000	25	42,651 - 110,100
	28	106,001 - 171,650	28	110,101 - 178,350
	33	171,651 - 336,550	33	178,351 - 349,700
	35	Over 336,550	35	Over 349,700
Married Filing Jointly	10%	$0 - 15,100	10%	$0 - 15,650
	15	15,101 - 61,300	15	15,651 - 63,700
	25	61,301 - 123,700	25	63,701 - 128,500
	28	123,701 - 188,450	28	128,501 - 195,850
	33	188,451 - 336,550	33	195,851 - 349,700
	35	Over 336,550	35	Over 349,700
Married Filing Separately	10%	$0 - 7,550	10%	$0 - 7,825
	15	7,551 - 30,650	15	7,826 - 31,850
	25	30,651 - 61,850	25	31,851 - 64,250
	28	61,851 - 94,225	28	64,251 - 97,925
	33	94,226 - 168,275	33	97,926 - 174,850
	35	Over 168,275	35	Over 174,850

Long-term capital gains and dividends are subject to a maximum tax rate of 15% (5% for taxpayers in the regular 10% and 15% tax brackets).

***These brackets have been adjusted for inflation in 2007; however, the IRS has not yet released the official amounts.**

Make year-end gifts to future heirs

If you will be subject to the estate tax in the future, consider gifting $12,000 in 2006 to each of your future heirs ($24,000 for married couples who split gifts). This helps reduce your future taxable estate.

While gifts to future heirs are generally subject to the gift tax, gifts that don't exceed these limits are not subject to gift tax. Gift appreciating income-producing property first to remove any future appreciation from your estate.

Once gifted, income generated by the property will be taxed to your future heir; if your heir is in a lower income bracket than you, family income tax will be saved. However, don't let the kiddie tax affect your gift. If your child is age 18 or under, some of the gift income may be taxed at your highest marginal tax rate.

Gift Exclusions & Exceptions

	2006	2007
Annual Gift Tax Exclusion	$12,000	$12,000

New kiddie tax rules

In prior years, children under age 14 paid tax at their parents' highest marginal rate on taxable investment income exceeding $1,700. Starting in 2006, children under the age of 18 are subject to this "kiddie tax."

If this tax affects your child, consider investing his/her earnings in a Section 529 college savings plan or Coverdell Education Savings Account. Both plans allow tax-free appreciation of investments. Parents can also invest a child's funds in the following:

- Series EE and I bonds
- Tax-free municipal bonds
- Growth stocks
- Mutual funds
- Real estate
- Other investments that can build wealth while deferring income tax until the child reaches age 18

However, tax savings should not be your top priority when selecting an investment. In addition, if you own a family business and hire your children to work for it, what they earn is not subject to the kiddie tax and also generates a business deduction. (The wages must be reasonable and for work actually performed.)

Earned income that isn't sheltered by the standard deduction will be subject to tax at the child's tax rate, not the parents'.

Wash-sale rule

Mutual funds often allow investors to choose whether they will receive ordinary income dividends and capital gain distributions in cash or have them automatically reinvested in additional fund shares.

If you choose to reinvest, your dividends and capital gains are still taxable income. Your basis of the new shares is the amount reinvested. Be careful when you reinvest because you may inadvertently get hit by the "wash-sale" rule, which basically provides that, if you sell a security for a loss but repurchase it

within 30 days, your loss is not allowed for tax purposes.

For purposes of the wash-sale rule, the acquisition of additional shares as the result of the reinvestment of dividends or capital gains is a purchase of other shares within the 61-day period beginning 30 days before and ending 30 days after the sale.

As a result, a loss on the sale of stock in the same fund may be disallowed. To avoid this, sellers of loss shares should in- struct the fund not to reinvest dividends for at least 30 days.

Bunch itemized deductions

Miscellaneous itemized deductions for any tax year are allowable only to the extent they exceed 2% of your AGI. Otherwise, they are lost.

The most common miscellaneous itemized deductions include:

- Unreimbursed employee business expenses, *e.g.*, transportation and lodging while away from home on business, business meals and entertainment, continuing education, professional journal subscriptions, professional dues, uniforms and job hunting
- Investment advisory fees, subscriptions to investment advisory publications, certain attorneys' fees and the cost of safe deposit boxes
- Tax return preparation costs

Bunch your miscellaneous itemized deductions in certain tax years to increase the deductible excess over 2% of AGI. Depending on the year you want to bunch, you can either pre-pay such expenses in 2006 or defer payment to 2007.

Caveat: Miscellaneous itemized deductions are not deductible when determining AMT. If you are subject to the AMT, consult your BKD advisor.

Consider an HSA

The rising cost of health care has caused many individuals and employers to switch from traditional health insurance coverage to high-deductible health plans (HDHP). If you or your employees are covered by an HDHP, a tax advantage is possible.

Taxpayers or their employers can contribute an amount equal to all or a part of their annual deductible to a health savings account (HSA). Contributions by an individual to an HSA are deductible above the line in computing AGI and distributions from an HSA are tax free to the extent they are used to pay for qualified, out-of-pocket medical expenses.

An HSA is a tax-exempt trust or custodial account established exclusively for the purpose of paying out-of-pocket medical expenses of the account beneficiary who is covered under an HDHP.

You can set up an HSA if (1) you are covered under an HDHP, (2) you are not covered by any other health plan that is not an HDHP, (3) you are not entitled to Medicare benefits and (4) you are not claimed as a dependent on another person's tax return.

An HDHP may either be an insured plan or an employer-sponsored, self-insured medical reimbursement plan. In 2006, individual, self-only coverage plans must have an annual deductible of at least $1,050 and an annual cap on out-of-pocket expenses not to exceed $5,250. For family coverage, the annual deductible must be at least $2,100, and the annual out-of-pocket expense cap cannot exceed $10,500.

For 2006, the annual contribution for an individual with self-only coverage is $2,700. For family coverage, the maximum annual contribution is $5,450. The deadline for making 2006 HSA contributions is April 16, 2007 (April 15 is a Sunday). HSAs can be set up through your insurance provider or financial institution.

Dependency Exemption

2006	2007
$3,300	$3,400

Basic Standard Deduction

	2006	2007
Married - Joint	$10,300	$10,700
Head of Household	7,550	7,850
Single	5,150	5,350
Married - Separate	5,150	5,350

Claiming aging parents & relatives

If you support your parents or relatives who receive Social Security benefits, plan to increase your dependency deductions.

To claim a dependency deduction for a parent or other relative, you must generally contribute more than half the total funds spent for his/her support. Social Security benefits are counted in the total amount and, thus, have a direct bearing on whether your contribution exceeds half of your parent's or relative's total support.

If you are in this situation, review the amount of support you have provided and compare it to other sources of income. It may be that, by contributing a small additional sum, you can bring your share to more than 50%.

If, as a group, you and your siblings contribute funds equaling more than half the total cost of supporting a parent—but no single individual contributes that amount—then, under a multiple support agreement, you may be able to claim your parent as a dependent.

To do so, you must provide more than 10% of the support, and siblings who do the same must sign a written waiver acknowledging they will not claim your parent as a dependent. When deciding which sibling should get the exemption, factor in tax brackets to make the most of the exemption among family members.

Avoiding estimated tax penalty

If you have substantial income in addition to your W-2 salary, you might find the amount of tax withheld from your W-2 salary isn't enough to cover your required estimated tax payments.

On each of four installment dates—set for the 15th of April, June, September and January—if you are subject to the estimated tax, you must pay 25% of your "required annual payment," generally the lesser of 100% of the tax shown on your return for the preceding year or 90% of your tax for the current year.

However, in figuring your 2006 estimated taxes, if your 2005 AGI was more than $150,000, you must pay the lesser of 110% of the tax on your 2005 return or 90% of your 2006 tax liability.

The applicable test is applied

Tax Alert

Weekly tax updates are available from our web site @ bkd.com. Every Monday you'll find helpful tips and news covering tax issues.

separately to each installment. Thus, if you underpaid an estimated tax installment, you can't avoid the penalty by increasing an estimated tax payment for a later period. However, a possible solution is increased withholding.

Income tax withheld by an employer is generally treated as paid in equal amounts on each of the four installment due dates. Therefore, if your employer withholds additional amounts for the rest of the year, the penalty can be retroactively eliminated.

Telephone excise tax refunds

On your 2006 individual tax return, you will be able to request a refund of the federal excise taxes you paid on long distance telephone service.

As previously covered in the September 2006 **BKD Advisor**, the IRS gave up its claim that this tax applies to modern long distance telephone arrangements. The standard refund will be between $30 and $60.

Alternatively, you may base your refund claim on the excise tax you actually paid between February 28, 2003, and August 1, 2006, but this will require digging out your old phone bills.

For most individuals, the standard refund will be the way to go, but you may want to use actual amounts if you had extraordinarily high long distance charges. ❖❖❖

New Medicare premium surcharge for 2007

With passage of the *Medicare Prescription Drug Improvement and Modernization Act of 2003*, a little-noticed provision was tacked on that added a "means" test. As a result, many taxpayers on Medicare will be subject to a new Medicare premium surcharge beginning January 1, 2007.

To determine if you are required to pay the premium surcharge for 2007, calculate your modified AGI: Start with your AGI on your 2005 federal income tax return (if you filed the long form, this is the figure at the bottom of page one of Form 1040). Add to this any tax-exempt interest, Series EE bond interest used for educational purposes and any excluded foreign-earned income.

You will be subject to the new surcharge if the result exceeds $160,000 for a married couple or $80,000 for a single individual or a married couple filing separately. This applies even if you didn't sign up for prescription drug coverage.

The surcharge rates range from 13.3% to 73.3% of the base Medicare premium for 2007, based on your modified AGI. For 2008, the rates will double, and for 2009, they will triple. See 2007 rates in the accompanying table.

In late November, the Social Security Administration is scheduled to send letters about this surcharge to affected seniors. ❖❖❖

FICA Wage Base

	Rate	2006 Wage Base	2007 Wage Base
Social Security	6.20%	$94,200	$97,500
Medicare	1.45%	Unlimited	Unlimited

2007 Medicare Rates

Married

If your 2005 modified AGI is More than...	but not over...	Your monthly premium surcharge is...
$160,000	$200,000	13.3%
$200,000	$300,000	33.3%
$300,000	$400,000	53.3%
$400,000		73.3%

Single

If your 2005 modified AGI is More than...	but not over...	Your monthly premium surcharge is...
$80,000	$100,000	13.3%
$100,000	$150,000	33.3%
$150,000	$200,000	53.3%
$200,000		73.3%

Recaps offer owners second bite of apple

by Matt Keeth, BKD Corporate Finance, mkeeth@bkd.com

When it comes to the succession of a company, different objectives drive every business owner: Some want to transfer ownership to the next generation or to their employees through a management buyout. Others strive to sell outright and retire, and some want to keep growing the business but are reluctant to take on the additional risk and personal obligations growth entails.

If you are contemplating the succession of your business, a recapitalization or "recap" is an option worth considering. Quite simply, recaps involve the restructure of a company's balance sheet as a way of providing liquidity to the owner and a source of growth capital for the business.

In essence, a financial partner—typically a private equity group (PEG)—uses a combination of cash, senior debt and subordinated debt to finance a partial acquisition of the company.

Generally, the business owner retains 20% to 40% ownership in the company, allowing for a "second bite of the apple" when the financial partner exits. Though majority recaps are more typical, minority recaps are also prevalent.

Should you recap?

Recaps are ideal in situations where the owner is enthusiastic about future growth opportunities but concerned about the personal financial obligations that growth typically demands.

As with most transactions, what PEGs look for in a company considering a recap is a strong, established business with a defensible market position, sustainable cash flows, a strong management team and a solid growth plan.

Recaps are a good option for companies and owners that want to accomplish the following goals:

- Limit financial risk and possibly eliminate personal borrowing guarantees
- Provide partial liquidity and a vehicle for complete liquidity
- Consolidate control when a large number of minority shareholders are present

(continued on page 12)

Business year-end tax planning strategies

Year-end planning for S Corps

In deciding whether to accelerate income into 2006 or defer it to 2007, keep in mind the income and losses of an S corporation are picked up on the personal returns of the shareholders. Accordingly, S corporation shareholders should coordinate S corporation and individual year-end planning.

For example, consider the passive activity loss limitation rules. If a shareholder doesn't materially participate in the corporation's business, any S corporation losses may be limited. In such a situation, deferring taxable income has little value if resulting losses cannot be deducted. Conversely, acceleration of taxable income may be appropriate.

Further, an S corporation shareholder can deduct S corporation losses only to the extent of his/her "basis" in the S corporation stock and the debt directly owed him/her by the S corporation.

This determination is made at the end of the S corporation tax year in which the loss occurs. Any loss or deduction that can't be used because of this limitation can be carried forward indefinitely.

If you want to claim a 2006 S corporation loss on your own 2006 return, but the loss exceeds your basis, consider lending money or making a capital contribution to the corporation before year end.

Business-owned life insurance

Businesses often insure the lives of owners and key employees, either at the request of lenders to fund buy-sell agreements or for other prudent business practices.

Provisions of the Pension Act apply to life insurance policies owned by businesses, including sole proprietorships issued or materially modified after August 17, 2006.

These new rules attempt to curb "dead peasant" insurance where employers take out life insurance coverage on rank-and-file employees largely for tax advantages. However, any business that is the beneficiary of an employee's life insurance policy is affected.

Life insurance death benefits are generally not subject to income tax; however, the new rules provide a business will be taxed on such death benefits in excess of premiums it paid unless certain requirements are met.

To escape death-benefit taxation, certain employee notice-and-consent requirements must be met *and* the insured must either have been an employee any time during the 12-month period before his/her death or have been a director or highly compensated.

Before the issuance of such a life insurance contract, three basic notice-and-consent requirements must be met, including:

- The employee must be **notified in writing** that the employer intends to insure the employee's life
- The employee must provide the employer **written consent**
- The employee must be **informed in writing** that the employer will be a beneficiary of any death benefits

Failure to meet these notice-and-consent requirements will result in the taxation of such life insurance benefits—**even if the insured was an owner, director or key employee, or if the insurance is funding a buy-sell agreement.**

In addition, if your business is the beneficiary of a life insurance policy **issued *or* materially modified after August 17, 2006**, it is required to file a new information return with the IRS for each year the contracts are owned.

Take Section 179 deduction

Under Section 179, you may deduct a limited amount of equipment purchases in the year the equipment is first used in the business; otherwise, depreciate or expense it over the next several years.

For 2006, up to $108,000 in qualified purchases may be deducted; however, this amount is reduced dollar for dollar if qualified purchases for 2006 exceed $430,000. These amounts are annually adjusted for inflation.

This expense deduction is further limited to your aggregate taxable income from all active trades or businesses. You may carry over

Retirement Plan Contribution Limits

Individuals age 50 and over can make elective catch-up contributions to their retirement accounts. The catch-up amounts are in addition to the regular contribution limits, the maximum allowed elective deferral retirement contributions:

	2006	2007
401(k), 403(b), 457 & SAR-SEP Plans - Under 50	$15,000	$15,500
401(k), 403(b), 457 & SAR-SEP Plans - 50 & Older	$20,000	$20,500
Traditional & Roth IRAs - Under 50	$4,000	$4,000
Traditional & Roth IRAs - 50 & Over	$5,000	$5,000
SIMPLE Plans - Under 50	$10,000	$10,500
SIMPLE Plans - 50 & Over	$12,500	$13,000

Elective deferrals are amounts an employee instructs his/her employer to take out of regular pay and put into a pension account. Employers with profit-sharing plans are required to contribute funds to employee pension accounts. The total sum of an employee's combined pension contributions can't exceed $44,000 for 2006; $45,000 for 2007. An employer's tax deduction for contributions can't exceed 25% of all employees' annual compensation, taking into account individual compensation.

The annual benefit limitation for defined benefit plans will increase from $175,000 in 2006 to $180,000 in 2007. ❖❖❖

to later years any allowable amount that exceeds the taxable income.

Offset income under 199 deduction

Businesses can claim a deduction under Code Section 199 to offset income from domestic manufacturing and other domestic production activities.

For 2006, the deduction is equal to 3% of the lesser of (1) the business's total taxable income (AGI, in the case of a sole proprietor) or (2) the business's "qualified production activities income" for the year. However, the deduction is limited to 50% of the W-2 wages paid by the business during the calendar year ending in the tax year.

Qualified production activities eligible for the deduction include:

- Manufacture, production, growth or extraction of qualifying production property (*i.e.*, tangible personal property, such as clothing, goods or food, as well as computer software or audio recordings) by a taxpayer either in whole or in significant part within the U.S.
- Film production (other than production of certain sexually explicit films), provided at least 50% of the total compensation, relating to the production, is for services performed in the U.S. by actors, production personnel, directors and producers
- Production of electricity, natural gas or water in the U.S.
- Construction or substantial renovation of real property in the U.S., including residential and commercial buildings and infrastructure, such as roads, power lines, water systems and communications facilities
- Engineering and architectural services performed in the U.S., relating to the construction of real property

It is important for businesses to calculate the tentative deduction and the W-2 deduction cap before year end. If the deduction cap limits the otherwise available deduction, then you may want to bonus out additional compensation.

Claiming telephone excise tax refunds

Your business will be able to request a refund of the federal excise taxes it paid on long distance telephone service on its 2006 tax return.

As previously covered in the September 2006 **BKD Advisor**, the IRS has given up its efforts to claim that this tax applies to modern long distance telephone arrangements.

Refunds are available for taxes paid between February 28, 2003, and August 1, 2006; however, the standard refund amounts available for individual taxpayers do not apply to businesses, so your business must base its refund claim on actual tax paid from old bills.

Defer certain advance payments

Accrual-method taxpayers may defer advance payments received **for goods** until the year they are accrued for financial accounting purposes.

Other advance payments are also eligible for deferral for accrual-method taxpayers until the year following receipt if the following conditions are met:

- Including the payment in income for the year of receipt is a permissible method of accounting for tax purposes.

- The taxpayer recognizes all or part of the payment in its financial statement for a later year.
- The payment must be for services; goods (other than goods for which the deferral method discussed above is used); the use of intellectual property; the occupancy or use of property ancillary to the provision of services; the sale, lease or license of computer software; guaranty or warranty contracts ancillary to the preceding items; subscriptions in tangible or intangible format; organization membership; or any combination of the preceding items.

The deferral method cannot be used for rent, insurance premiums, payments on financial instruments, payments for certain service warranty contracts, payments for warranty and guaranty contracts where a third party is the primary obligor, payments subject to certain foreign-withholding rules and certain payments made in property.

If an advance payment is only partially attributable to an eligible item, it may be allocated among its various parts, and the deferral rule may be used for the eligible part.

To change your current procedures to defer eligible payments, you must include a special filing with your tax return, notifying the IRS you are changing.

Take advantage of 12-month rule

Prepaid expenses are generally not deductible in the year of payment; however, a provision commonly referred to as the "12-month rule" allows for the deduction of certain prepaid expenses.

This rule applies to amounts paid to create or enhance intangible rights or benefits that don't extend beyond (1) the earlier of 12 months after the first date the taxpayer realizes the right or benefit or (2) the end of the tax year following the tax year in which the payment is made.

The 12-month rule is especially applicable to prepaid insurance premiums, taxes and licenses and service contract costs.

Standard Mileage Rates

2006	
Business	44.5 cents per mile
Charitable	14 cents per mile
Medical & Moving	18 cents per mile
2007	
Business	48.5 cents per mile
Charitable	14 cents per mile
Medical & Moving	20 cents per mile

Avoiding surtax

Businesses should decide when and how to shift income and deductions between 2006 and 2007 to benefit from the deferral of income and the acceleration of deductions; however, to avoid the corporate surtax, acceleration of income may be advisable.

C corporation taxable income between $100,000 and $335,000 is subject to a 5% surcharge, resulting in a rate of 39% to phase out the benefits of the 15% and 25% brackets that cover a corporation's first $75,000 of taxable income.

If you project your business's 2006 taxable income to be less than $100,000 and to be more than $100,000 in 2007, consider accelerating income and/or deferring deductions to raise 2006 taxable income to $100,000.

There is a similar surcharge for C corporations with taxable income between $15 million and $18,333,333. Affected corporations should also try to shift income and expenses to reduce this surtax.

Avoiding personal holding company tax

A closely held C corporation is subject to the personal holding company (PHC) tax if 60% or more of the corporation's gross income consists of PHC income, which includes interest, dividends, rents and royalties among other things. (**Note:** Closely held rental corporations are excluded.) Undistributed PHC income is taxed at a flat rate of 15%.

A closely held rental corporation is basically one (1) whose net rents are 50% or more of its gross income and (2) whose *undistributed* dividend, interest and certain other PHC income does not exceed 10% of its gross income.

If your corporation meets the 50% test but fails the 10% test, seriously consider paying a dividend so undistributed PHC income is less than 10% of the corporation's gross income.

Further, if your corporation is in danger of falling into PHC status, determine whether it is possible to either accelerate business income or defer PHC income. (The above **Advisor** item covers only some of the strategies for avoiding this tax.)

Deducting nonowner bonuses

An accrual-basis corporation can take a 2006 deduction for bonuses paid in 2007:

- If the employee given the bonus doesn't own more than 50% in value of the corporation's stock
- If the corporation properly accrued the bonus on its books before the end of the current tax year
- If the bonus is actually paid within the first 2½ months of the following tax year

In addition, the bonus won't be taxable income to the employee until 2007.

However,the 2006 deduction won't be allowed if the bonus is paid by the following:

- A personal service corporation to an employee/owner
- An S corporation to an employee/shareholder
- A C corporation to a direct or indirect majority owner

Simplified travel rates updated

The IRS has updated the simplified "high-low" per diem rates for business travel. The new rates are effective for lodging and meal and incidental expenses (M&IE) paid to reimburse employees for business travel costs on or after October 1, 2006.

Instead of reimbursing actual, substantiated expenses, your business may pay a per diem amount to an employee for business travel.

If the rate paid does not exceed IRS-approved maximums, and if certain substantiation requirements are met—time, place and business purpose—the reimbursement is not subject to income tax or payroll tax withholding.

IRS per diem amounts are based on rates paid by the federal government to its workers, which vary from one locale to another.

Your business can use the location-based per diem rates, but it can also use the simplified high-low rates to reduce recordkeeping costs. Under this method, there is one per diem rate for "high-cost" areas and another rate for all other areas.

Under the optional high-low method for post-September 30, 2006, business travel has a high-cost area per diem rate of $246 ($188 for lodging and $58 for M&IE). These rates are up from $226 ($168 for lodging and $58 for M&IE.)

The per diem rate for all other localities is $148 ($103 for lodging and $45 for M&IE). These rates are up from $141 ($96 for lodging and $45 for M&IE).

Additional details are available in IRS Publication 1542 accessible on the IRS web site: **www.irs.gov**.

Planning for partnership losses

A partner's share of partnership losses is deductible only to the extent of his/her partnership basis and amount at risk as of the end of the partnership year. The amount of this basis and at-risk can generally be increased by making a capital contribution or a loan to the partnership or by guarantying partnership debt.

The impact of the passive activity loss limitation rules must also be considered. Under these rules, losses from passive activities can only be deducted to the extent of income from other passive activities. Rental real estate income is almost always passive.

However, exceptions apply to real estate professionals. Further, a partial exception applies to lower-income taxpayers' real estate rental losses.

In addition, limited partners almost always have passive activity interests, but if a limited partner actively participated in a partnership business for at least 500 hours during the year—or otherwise meets certain narrow exceptions—he/she is treated as actively participating and, thus, not subject to the passive loss limitations.

If you own an interest in a real estate partnership, consult your BKD advisor about how to limit the reach of these limitations. ❖❖❖

Travel Rates

New simplified per diem travel rates became effective October 1, 2006. Employers can give employees these per diem allowances instead of reimbursing actual business travel expenses. Use of the per diem rates greatly simplifies recordkeeping requirements needed to substantiate deductions for business travel.

	Until 10/06	Beginning 10/06
Lodging, meals & incidentals "high-cost localities"	$226 per day	$246 per day
Lodging, meals & incidentals other localities	$141 per day	$148 per day
Meals & incidentals only "high-cost localities"	$58 per day	$58 per day
Meals & incidentals only other localities	$45 per day	$45 per day
Transportation industry: meals & incidentals continental U.S.	$52 per day	$52 per day
Transportation industry: meals & incidentals outside continental U.S.	$58 per day	$58 per day

Retirement planning: it's a marathon

by Randy Saul, BKD Wealth Advisors, rsaul@bkd.com

Most of us take more time to plan our vacation than we do our retirement. The time we *do* spend planning for retirement is usually spent scrutinizing our investment portfolio instead of considering what will happen after we are gone. Given the current uncertainty of our nation's inheritance tax laws, why bother?

The answer lies in the fact that our retirement accounts often hold the largest percentage of our assets, and we are responsible for the care of those assets as never before.

Many people simply roll their assets out of their 401(k)s or 403(b)s and into individual retirement accounts (IRA)s and then name their spouse as the primary beneficiary of the IRA account. If they are somewhat engaged in the planning process, they will also name their children as the contingent beneficiaries. Unfortunately, this is as far as many of us get with estate planning as it pertains to our retirement accounts.

An annual review of your plan or the retirement planning process can be very beneficial, and year end provides an opportune time for these activities.

Following are four steps that can help you review your plan and plan more effectively. Some steps are simple, others more complex but *all* are important and necessary in caring for your assets more responsibly.

Conduct an annual review

The first step in an annual review is a simple but necessary question: Are you still married to the same person? If not, take time to change your primary beneficiary. Obtain the necessary paperwork from the current custodian of your IRA and send it through the proper channel to record the change.

If you are still married to the same person, what is the health status of your spouse? If a serious health condition exists, consider changing the primary beneficiary designation. Because one's health status can change, it is important to review this issue every year.

Consider converting to Roth IRA

The second step is a bit more complex and difficult to assess. With the appearance of Roth IRAs and recent legislation concerning Roth conversions, we are faced with new decisions. Beginning in 2010, many individuals who haven't converted to a Roth will be able to.

When considering a conversion, you'll have the opportunity to revisit your primary beneficiary designation. There are many planning alternatives because Roth IRAs don't require a minimum distribution during your lifetime, and there is no tax due on the Roth when distributions are taken.

Because Roth IRAs are so tax efficient, we are certain to see them used creatively in estate planning as they grow in popularity and as 2010 draws closer.

"Stretch" your IRA

The third step: Consider your current contingent beneficiaries. Again, for many this is a simple decision of dividing the IRA equally among their children. But situations change, and this decision should be reviewed at least annually.

Current IRS regulations stipulate a designated beneficiary can stretch distributions on an inherited IRA over his/her lifetime. Update your custodial agreement to accommodate "stretch" IRAs or consider transferring it to a custodian that offers this type of IRA.

Over time, discuss with your adult children what their estate plans call for. Learning to plan better together to take advantage of existing laws is also important.

This is not an easy or comfortable issue for a family to discuss, but it can be vital to both generation's estate planning success.

Stay engaged

The fourth step is to bring togeth-

Market commentary:

by Jeff Layman, BKD Wealth Advisors, jlayman@bkd.com

As anticipated, second-quarter real economic growth slowed from an above-average pace, moving toward long-run trend growth of 3.00%. Revised gross domestic product (GDP) data indicated real growth moderated to 2.60% during the period. With a significant decline in the housing market and high energy prices, the third quarter may show further deceleration.

Federal Reserve (Fed) Chairman Ben Bernanke believes the housing market correction will reduce economic growth by a full percentage point in the second half of this year.[1] Interestingly, this housing recession has primarily been caused by excessive price appreciation (which has negatively affected affordability) rather than the typical cause of rising interest rates.

Over the summer, investors feared the combination of $78 oil, continued Fed rate hikes and the decline in housing activity would lead to a severe economic slowdown in 2007. Some economists even predicted a recession led by a substantial retrenchment in consumer spending. However, since then, oil and gas prices have dropped by about 25% and the Fed chose to "pause" at its last two meetings.

Recent economic data indicates a moderation in economic activity, and inflation fears have been reduced given the decline in commodity prices. Together, these factors increase the chance of a "soft landing" for the economy, whereby inflation is kept under control and the economy grows at a reasonable pace.

Given this recent economic data—and the fact that two years' worth of Fed tightening are already in the pipeline—we do not believe the Fed will raise rates again in 2006. In fact, bond and borrowing rates have begun to move down, implying the Fed may actually reverse course and lower interest rates in 2007.

The Fed's future actions will continue to be very "data dependent." Our expectation is deterioration in employment data would be the catalyst that causes the Fed to begin to ease.

Equity markets

The two most significant headwinds investors faced in 2006—high energy prices and rising interest rates—eased during the third quarter. Oil declined from a peak of $78 to around $60 per barrel, and the Fed opted to stay on the sidelines once again at the September Federal Open Market Committee (FOMC) meeting. The

not a sprint

er all the parts of your retirement plan and coordinate them. Many of us work for more than one employer throughout our careers—and some of us log time in more than one career—so it's important to regularly take stock of the entire retirement picture.

If you're planning to retire in the next five to 10 years, schedule a joint meeting with your attorney, accountant and investment advisor. Use current laws to your advantage and listen to your team of professionals. The knowledge each member brings to the table could have a major impact on your planning decisions, and sharing information can help ensure a workable plan.

The retirement planning process is not a sprint—*it's a marathon*. Your objectives and circumstances can change along the way. Staying engaged in the process is important, and it may help boost your confidence as you near the finish line. ❖❖❖

slower economic growth anticipated in 2007

result: renewed investor optimism, prompting a rally to new highs for the year for the S&P 500 index, which reached levels not seen since early 2001.

Whereas energy, materials and industrial stocks drove the market rally that lasted from January through May, the current rally has been much more broad based.

Every major economic sector in the S&P 500 large-cap index has contributed positive returns in 2006, with nine of 10 posting year-to-date returns above 4.50%. The laggard is the technology sector, which is up 1.56% for the year. Narrow rallies (those driven by only a few sectors) are generally less sustainable than those that are broad based.

While international returns continue to outpace U.S. equity returns, the outperformance is entirely related to the weakness of the dollar vs. other currencies. Excluding the currency effect, the return for the MSCI EAFE (Morgan Stanley Capital International Inc.—Europe, Australasia, Far East) so far in 2006 is 6.01%, which is below large-cap U.S. stock returns. Currencies can be volatile and difficult to predict, therefore the relative return advantage of international stocks may also become more undependable going forward.

Fixed income market

After the Fed's decision to "pause" at both the August and September FOMC meetings, bond investors effectively began to price an easing into the market during the third quarter. The 10-year Treasury Note yield declined from 5.14% at the end of the second quarter to 4.63% by the end of September. The prior level was roughly in line with the Fed Funds rate of 5.25%, last raised at the June FOMC meeting.

The .50% decline in rates indicates a bond market not too fearful of inflation, but also anticipates slower economic growth in 2007. Recent declines in energy and other commodity prices should calm inflation fears, causing the Fed to stay on the sidelines the remainder of 2006.

The decline in yields during the quarter helped to boost total returns from bonds, as bond prices rose slightly for the first time in several quarters. Total bond returns were roughly flat at the end of the second quarter, but the combination of coupon income and price gains resulted in a more significant return during the third quarter.

Investment outlook

During the second quarter, profits for S&P 500 companies continued a long string of strong gains, marking the 17th consecutive quarter of double-digit earnings growth. Our expectation is corporate earnings will begin to slow (along with the pace of economic growth) because of slowing sales volumes and compression in profit margins.

Offsetting this to some degree is the reduction in share count from corporate repurchases of stock and higher interest income, both resulting from the large cash positions that most S&P 500 companies currently maintain.

Strong gains posted by stocks during the third quarter reflect investors' perception of an improved outlook for the economy. Despite this rally, we continue to believe stocks are attractively valued at under 16 times their 2006 earnings. With the Fed on the sidelines, inflation expectations moderating and consumer spending stabilizing, the future looks better for financial assets.

Recent headlines indicate the Dow Jones Industrial Average reached a new all-time high of 11,870 during the first week of October. Although impressive, this index is just now surpassing the previous record of 11,750 set in January of 2000.

Meanwhile, the S&P 500 Index is still 10% below its record high set in March of 2000. S&P 500 earnings have more than doubled since then, making this ascent toward record levels much healthier and sustainable than that of six years ago. Given the recent improvement in the economic backdrop, there is a strong likelihood the S&P 500 will join the Dow at record levels in 2007. ❖❖❖

[1] **Source: Bloomberg, October 4, 2006**

Equity Index Returns

	3Q 2006	2006 YTD
S&P 500	5.67%	8.53%
S&P Mid-Cap 400	(1.08)%	3.12%
Russell 2000	.44%	8.69%
MSCI EAFE	3.93%	14.49%

Bond Index Returns

	3Q 2006	2006 YTD
Lehman Aggregate	3.81%	3.06%
Lehman Municipal	3.41%	3.69%
10-year Treasury Yield	4.63%	

Recaps offer owners second bite of apple. . .

(continued from page 6)

- Buy out dissenting shareholders
- Grow the company with help from industry veterans

Recap pros & cons

Recaps offer a number of advantages to business owners, but, above all, they allow owners to diversify their investment portfolio. Many times, business owners have a large portion of personal wealth tied up in the business.

Recaps also allow current management to continue operating the business. Other advantages include:

- Employees' jobs are typically protected
- Management may be allowed to buy into the new company
- Provides time to groom a successor
- Enhances the company's marketability
- Reduces financing strain when transferring ownership to the next generation

Recaps are not the best option in every situation, especially those where the business owner wants to exit quickly. The business must also have the ability to take on debt without overleveraging the balance sheet, which can be detrimental to the company's profitability.

Finally, potential investors won't be interested in a company with limited marketability. The financial partners themselves must first see a viable exit strategy. The following is an example of how a recap works:

- ABC Company is sold in first transaction to a PEG for $30 million (MM) and recapitalized as NewCo
- ABC Company had $30MM in revenue for a multiple of revenue of 1x
- ABC Company had $5MM in earnings before interest, taxes, depreciation and amortization (EBITDA) for a multiple of EBITDA of 6x
- NewCo is recapitalized with $20MM in debt (combination of senior and subordinated) and $10MM in equity
- PEG invests $8MM in equity for an 80% ownership stake
- Seller reinvests $2MM of proceeds for a 20% ownership stake
- For the next five years, revenues grow at 10% annually and EBITDA margins hold steady. Because of the company's profitability, the entire debt load from the first transaction is paid down
- Revenues reach $48.3MM with EBITDA of $8.05MM
- NewCo is sold five years after the first transaction at the same multiples (1x revenue and 6x EBITDA) for a transaction value of $48.3MM
- Seller nets $28MM in the first transaction and $9.6MM in the second transaction for a pre-tax and pre-transaction fee total of $37.6MM
- PEG receives $38.7MM for its $8MM original investment

As the example illustrates, recaps can be attractive options for owners and financial partners because they provide owners with immediate asset diversification and the possibility of a sizeable "second bite of the apple."

Though not the best option for every company or owner, if the circumstances are right, they can be an excellent succession planning strategy. ❖❖❖

Remember to disclose reportable transactions

Certain transactions known as "reportable transactions" are required to be specially disclosed to the IRS on your tax return. Failure to do so can result—per transaction—in penalties as high as $100,000 for individuals and $200,000 for C corporations.

Even innocent omissions of seemingly insignificant transactions can result in large penalties. Consider this when compiling your year-end tax information.

For a more detailed explanation, go to **bkd.com/service/tax/ReportableTransactions.htm** or contact your BKD advisor. ❖❖❖

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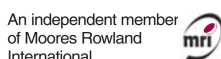

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